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Independent National Moneys and International Currency Integration

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Introduction

The post-July 1997 instability in exchange rates, first in Asia and subsequently around the globe, raises again the question of whether we can improve our systems for foreign-exchange management. Past currency crises have all had roots in a variety of problems, but exchange-rate instability has magnified each crisis and spread it into sectors and countries that should have been spared.

The fact that the Asian crisis and the final preparations for the euro took place at the same time suggests obvious questions. Are the countries in the EMU taking the right step by unifying their currencies and reducing the scope for foreign-exchange variability? Should Asian and Latin American countries study this option? Or are countries like the UK right in maintaining political control over currencies at the national level? Should the IMF and the United States adopt a preference for one approach or the other?

This essay supports currency integration as a natural development in economic globalization — indeed, a market-led trend —which should be embraced to promote international economic growth. Because of the mutual nature of currency integration, international initiatives should complement national measures in promoting this trend.

The body of practical knowledge on currency integration is mounting steadily, as reported notably in the IMF's staff research. Nonetheless, currency integration is still a relatively novel idea. The purpose of the following paragraphs is to facilitate consideration of currency integration by presenting an argument in its favor that is brief, yet relatively comprehensive and, most importantly, practical.

Why National Moneys?

Historically, national moneys were established for profit (seigniorage), to facilitate trade, and to lower borrowing costs. Over time, most governments have come to agree that it is preferable to meet fiscal needs without manipulating monetary policy to expand seigniorage. They now also tend to agree, at least in principle, that they should not use their control of money and banking to under-price loans. However, governments still regard facilitating trade as a legitimate objective of monetary policy, and, in recent decades, they have developed a new objective for monetary policy — lowering real wages to expand industrial employment in recessions.

This last objective is based on the observation that labor can only bargain for its nominal wage, not its real wage. The nominal-wage bargain can result in unemployment when the price-level is lower, and the real wage higher (*i.e.*, when the terms of trade are worse), than foreseen.

So, governments occasionally use inflations or devaluations (sometimes unwittingly, or as a by-product of expansionary fiscal policies) to temporarily lower real wages, improve national competitiveness and reduce unemployment. A round of such devaluations occurred at the time of the Great Depression in the 1930s.

Currency Coordination Since Bretton Woods

After the Depression and World War II, the industrial democracies wanted to reorient exchange-rate policy away from competitive devaluations and toward rebuilding trade. So, they set up a system of fixed exchange parities supported by the newly created IMF.

Over time, the monetary policies of the main economies diverged, propelled apart by a variety of economic and political factors. In 1971, these countries abandoned fixed parities. Since then, the IMF has considered that some form of floating exchange rates is most appropriate for larger economies, particularly where there is some freedom of capital movement. However, the Fund has condoned fixed parities in cases like the franc zone in Africa and currency boards in the British system. In some cases, it has also advised small countries with stable monetary and fiscal policies to set an exchange-rate target against a major currency, or against the SDR after its creation in 1969.

Consistently with the IMF's view, most sizeable countries adopted some form of floating exchange rates after 1971. The stability of these floating exchange rates has been a problem. In particular, the IMF and national policy makers have had trouble dealing with capital flows, especially as flows have accelerated in the 1990s.

This is a special problem for low-income economies. International capital flows have become an important factor in raising incomes in these countries, but the markets for these countries' currencies are narrow and therefore especially vulnerable to external shocks. Unfortunately, policy interventions that reduce fluctuations in capital flows usually diminish their amount also.

The basic problem is that it is impossible to have a simultaneous combination of (1) an independent monetary policy, (2)unchanging exchange rates, and (3) free international trade and investment. At any moment of time, the presence of any two of these conditions will preclude or eliminate the third.

Policy makers in many countries have tried to achieve all three objectives simultaneously, targeting interest rates and exchange rates while freeing trade and attracting investment. As one objective or another was jeopardized, policies shifted, sometimes continuously and unpredictably, to try to plug the holes.

The phases through which international currency coordination has passed since 1945 can be characterized as choices of the objective to be sacrificed, or given least emphasis, out of the three above.

- The Bretton-Woods arrangements originally agreed to sacrifice objective #3, freedom in investment flows, subject to occasional adjustments in exchange rates in case of sustained imbalances.

- After a prolonged build-up of systemic imbalances, it was decided in 1971 to abandon fixed parities, thus further de-emphasizing objective #2, exchange-rate stability, but permitting growth in capital flows.

- With the growth in capital flows and accelerating frequency of currency crises in the 1990s, more countries have expressed interest in currency integration, which sacrifices objective #1, independent monetary policies. Returning to some form of the Bretton-Woods approach has also been given more attention, with Malaysia being a recent test case.

Domestic Policy Approaches to Currency Risk

Stabilization through Fiscal Policy

One way of attempting to minimize the contradictions inherent in setting too many inconsistent macroeconomic goals is to devote tax and spending policy to macroeconomic stabilization. In many cases,

fiscal "austerity" drives for macroeconomic stabilization have been consistent with making improvements in the microeconomic equity and efficiency of public finance. However, stabilizing fiscal policy has equally often been implemented with little regard for microeconomic rationality, especially under time pressure and constrained by institutional weaknesses.

Furthermore, fiscal policy's macroeconomic efficacy has declined over time, as the leading source of monetary instability has shifted from capital flows associated with goods markets, which fiscal policy affects directly, to capital flows associated with markets for financial assets, which fiscal policy affects only indirectly.

Stabilization through Banking Regulation

A second domestic approach to macroeconomic stabilization is to adjust banking practice to currency risk. Banks should clearly manage currency exposures carefully. Where unpredictable external events could cause extreme exchange-rate fluctuations in minor currencies, prudential regulation of currency positions could rationally be strengthened to the point of being nearly prohibitive, thus resembling currency or capital controls.

Such banking regulation can transform and mitigate the losses from currency risk, by protecting banks from the initial impact of currency fluctuations. However, capital moves through many channels, so that banking regulation by itself is not sufficient to insulate the entire economy from exposure to currency risk.

Furthermore, the losses from barriers to capital flows are considerable even when the form of the barrier is a microeconomically rational response to macroeconomic instability. Fixing the problem of instability at its root would be preferable, if it is possible.

An International Approach: Currency Integration

This note bases its advocacy of currency integration on a preference for free international trade and investment, and on the judgment that exchange-rate stability promotes trade and investment better than discretionary monetary policy. Thus, of the three inconsistent macroeconomic objectives, maintenance of independent currencies and monetary policies is the one to sacrifice.

There are a variety of ways to integrate currencies: union, adoption, affiliation, and perhaps others.

- *Union*: Where two or more countries wish a symmetrical procedure for currency integration, a new common currency can be created by pooling the countries' monetary bases. This is the case of the euro.

- *Adoption*: Where a small economy is clearly in the currency zone of a larger one, a simple way of integrating currencies is for the smaller economy to adopt the currency of the larger. Panama is an example of this approach.

- *Affiliation*: Short of being willing to adopt a foreign currency or a new international one, a country can affiliate its currency with a reserve currency by instituting a "currency board" system, such as Argentina's.

Ideally, the currency board holds reserves of the reserve currency equal or greater in value (at a given parity) to the local currency's monetary base. The currency board's job is to exchange the local currency and the reserve currency for one another at par and on demand, meaning that emission and redemption of the local currency occur at the initiative of the public. The currency board is indifferent to the volume of local currency it redeems or emits in exchange for the reserve currency, and it always has sufficient reserves to redeem the local currency's whole monetary base at par.

The public should always be free to hold various currencies, and in the case of a currency board, this applies to both the currency board's money and the reserve currency. The amount of local currency in circulation would then depend on the public's effective demand for that currency, while the total money supply in the economy (local currency plus reserve currency) would depend on the demand for money as such. The local currency would differ in name and appearance from the reserve currency, but it would be, in effect, only a denomination of the reserve currency.

To Integrate or Not to Integrate

Benefits

Whatever technique is used to integrate currencies, there are a number of potential benefits.

- Fewer exchange-rate and monetary-policy shocks, both from domestic sources and from external causes like competitive devaluations. (On adjusting to the shocks that do occur, see "Adjustment Policy," below.)

- Enhanced and more globally uniform regulatory standards for financial institutions, particularly in emerging markets.

- Reduced transaction costs.

- Increased trade in financial services.

- Transparent pricing and better integration of product markets.

These potential benefits can be very important for low-income countries with less developed financial sectors. However, benefits like product-market and financial-market integration do not necessarily follow from currency integration automatically, although currency integration does facilitate them. Authorities should take additional steps to encourage market integration more explicitly.

Concerns

- Central Banking

Establishing a currency board is sometimes equated with abolition of the central bank. It is true that a currency board is not a bank and does not lend its currency to anyone. However, currency integration, through a currency board or otherwise, by no means eliminates the need for central banking, where this is understood to refer to the familiar tasks of formulating prudential regulations, supervising banks' compliance, penalizing non-compliance, holding reserves, administering deposit insurance, clearing inter-bank transactions, financing banks' short-term liquidity needs, performing lender-of-last-resort functions in cases of more serious systemic liquidity needs, and managing the restructuring or exit of banks as required.

One of the steps in currency integration is therefore to ensure that central-banking functions will continue. In particular, lacking the ability to emit fiat currency, the central bank and the commercial banks will need to line up precautionary sources of reserves. This is possible through a number of arrangements, such as establishing foreign banks in the country, branching of foreign banks, foreign investment in domestic banks, stronger correspondence relationships and lines of credit with foreign commercial banks, emergency roll-over clauses in loan agreements, lines of credit with the reserve currency's central bank, and lines of credit with the IMF.

Although these arrangements provide only finite liquidity support, this is also the case of conventional lenders of last resort. Indeed, one of the lessons of the Asian crisis was the need to "bail in" private international capital, precisely due to the inadequacy of lenders of last resort, even with independent currencies.

- Transitional issues

Currency integration needs to be implemented without inadvertently creating a deflationary shock by choosing the wrong parity or by dollarizing with insufficient dollar reserves. The risk of a deflationary shock is less if the conversion is made at a time when exchange rates are not changing, or when the old local currency has vanished in hyperinflation.

Similarly, fiscal affairs should be arranged so that any loss of seigniorage is manageable. Again, this is usually a minor problem during a period of stable and low-to-moderate inflation, or after hyperinflation. In the case of full dollarization, loss of seigniorage would ideally be avoided by buying the dollars needed for circulation through a currency swap between central banks, rather than through a sale of earning assets by the dollarizing country.

Institutionally, any confusion between the three functions that are occasionally combined in "central banks" — currency emission, banking regulation, and governmental treasury operations — needs to be disentangled before the transition to currency integration.

- Adjustment Policy

The main concern regarding currency integration is probably the constraint it imposes on adjustment policy. With an independent currency, policy makers can consider proactive and reactive exchange-rate adjustments as useful tools for improving, maintaining, or regaining national competitiveness in the face of pressures like increased prices of imports or rising local wages.

Whether currency depreciation is the appropriate response to such challenges is doubtful, however. There are both internal and external issues.

Internally, most monetary authorities now support a policy of credible commitment to a low, stable rate of inflation. Such a policy shifts the responsibility for wage and price decisions' impacts away from the monetary authority and onto private agents. It also gives the private sector credible information about future price levels, which it needs to make good decisions.

As currency depreciation is the external counterpart of domestic inflation, in principle the same monetary authorities that target low inflation should also try to present the private sector with a credible commitment to stable exchange rates. This is widely agreed, and there is relatively little interest in a pro-active policy of devaluation and inflation to stimulate long-term growth. Rather, independent national moneys are more often managed in a way that resembles currency integration, through the use of the exchange rate as a nominal anchor for a low, stable rate of inflation. This policy can generate benefits similar to currency integration when the exchange markets are quiet, and it can be used as a preliminary step to currency integration.

However, there does remain a desire to allow currency depreciation to occur (or accelerate) *reactively*, especially to deal with deterioration in the external terms of trade, such as falling world prices for a country's exports. In this scenario, currency depreciation is not inflationary, but a barrier to potential deflation or recession.

As a general policy, nations should deal with their external terms of trade by encouraging a dynamic process of investment in industries that are profitable at world prices. Especially for low-income countries, openness to trade and capital flows, and flexibility in domestic markets, are the best policies for promoting investment in productive capacity that is competitive in world markets and reacts efficiently to changes in world prices.

Reactive currency depreciation, like tariff protection, tends to substitute for and even discourage both international capital flows and flexibility in domestic markets, through such impacts as lowering rates of return in dollar terms and validating inflexibility in labor costs. In contrast, international currency integration, especially as a part of a package of sound basic policies that promote internal markets' flexibility, avoids these pitfalls, and is more attractive to investors who are oriented to world markets.

Externally, policy makers who count on the benefits of currency depreciation must hope that policy makers in other countries will not do the same. However, the incentives to devalue are nearly symmetric between countries, leading to competitive devaluations. The system of many flexible currencies constitutes a risk of global instability arising from local problems. Like the Bretton-Woods system before it, currency integration can be seen as a "cooperative solution" to the competitive-devaluation game, but with free international capital flows instead of internally oriented national monetary policies.

The Theory of Optimal Currency Areas

One approach to comprehensively evaluating the benefits and concerns regarding international currency integration is the theory of optimal currency areas. Some studies use the theory's criteria to rank regions according to their potential benefit from currency integration. While the results do not suggest that the existing global pattern is optimal, neither are they able to establish whether currency integration in any specific area would be beneficial or harmful in an absolute sense.

These studies also lose some of their relevance in the longer run, because currency integration facilitates international trade, investment, and labor movements, which thus cease to be exogenous factors in the evaluation of exchange regimes. As has been remarked in the case of the European Monetary Union, currency integration is perhaps most naturally seen as part of a broader set of policies that reduce barriers

in international trade and finance. The full set of policies may potentially have a profound effect in the long run on the location of industries and households, thus undermining the assumptions of the theory of optimal currency areas. Indeed, the theory of optimal currency areas may be less a way of evaluating currency integration than a way of identifying the policies that should accompany currency integration in a consistent package of pro-trade initiatives.

Private Currency Integration

The private sector knows to expect exchange-rate instability. It recognizes that there is always a political temptation to engage in competitive monetary policies, especially when international monetary authorities are flexible on exchange-rate policies. The private sector also knows that shocks occur and that exchange rates do not adjust stably.

One market response to expected exchange-rate instability is private currency integration — or "dollarization" in particular. In some Latin American countries, more than half of all bank deposits are denominated in U.S. dollars. (This private, voluntary process seems more likely to result in "optimal currency areas" than the political process has so far.)

While private dollarization stabilizes the affairs of those who dollarize, it may shrink the market for the local currency and thus increase its vulnerability to fluctuations, or even "currency crises" — large, sudden increases in the private sector's preference for dollars (or other strong currencies). Such crises have been attributed to various causes, including fiscal deficits (where the deficit raises absorption and rising absorption depreciates the currency), term-mismatches in financial intermediation (given the multiple possible equilibria in lenders' expectations), and attacks on currencies by hedge funds. Whatever the surrounding environment may be, the "crisis" is constituted by a rapid flight from and depreciation of the currency.

Thus, authorities may see dollarization as a potential threat. One possible response is currency control. Alternatively, authorities may try to preempt or reverse dollarization by doing more to stabilize their local currencies. However, even stabilization has sometimes not convinced the private sector to de-dollarize.

International Policy on Currency Integration

Perhaps the crucial factor in decisions about currency integration is international policy. Much of the impetus for an independent national currency originates not in domestic concerns, but in the instability of other countries' currencies.

Furthermore, a major concern about implementing currency integration is the degree to which the international community will support national liquidity needs during times of difficulty. Currency integration is inherently multinational.

The leading voices in international policy are those of the United States and the IMF. These two influential actors have occasionally supported currency integration, but this support could be more systematic.

The United States has a clear national interest in international currency integration, especially around the dollar, although not for reasons of seigniorage. Simply, currency integration is good for trade and investment, and currency integration around the dollar is especially good for trade in U.S. institutions' financial services.

This argues in favor of U.S. support for integration of foreign currencies with the dollar, perhaps through currency swaps between U.S. Federal Reserve Banks and foreign central banks. Currency swaps might deprive the United States of a small amount of seigniorage, which it would receive if foreign central banks had to accumulate dollars on their own. However, swaps have no direct costs, and they would help unify financial markets, thus creating opportunities for U.S. financial firms and benefiting the entire U.S. economy.

The IMF is flexible about the choice of exchange regime. It should consider adopting currency integration as a preferred element of its package of sound basic policies, and help move the international system in this direction.

Two main tasks stand out for the IMF. One is to advise and assist small economies in integrating their currencies with one of the major reserve currencies. The other is to help the major economies to establish a narrow band around fixed exchange-rate parities as a common goal of their economic policies.

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